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No. 76-1359

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

BANKERS TRUST COMPANY,
Petitioner,

v.

SAMUEL MALLIS and FRANKLYN KUPFERMAN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER BANKERS TRUST COMPANY

CHARLES LEEDS
JACK H. WEINER
Counsel for Petitioner
Bankers Trust Company
1775 Broadway
New York, New York 10019

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Opinion Below

The opinion of the United States District Court for the Southern District of New York dismissing the complaint is reported at 407 F. Supp. 7 (A.128-137).[1] The opinion of the court of appeals (A.154-165) is not yet officially

[1] "A." refers to the Appendix heretofore filed with the Court. "App." refers to the Appendix at the end of this Brief.

reported, but is unofficially reported at CCH Federal Securities Law Reporter at paragraph 95, 823. The memorandum Opinion of the Trial Court, Supreme Court, New York County in the related case of *Mallis* v. *Kates, et al.* (A.88-90) is not officially reported.

Jurisdiction

The judgment of the Court of Appeals was entered on January 3, 1977 (A.166-167). A timely Petition for a Writ of Certiorari was filed on April 4, 1977, and granted on May 23, 1977 (A.168). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

Statutes and Rules Involved

The relevant provisions of the Securities Exchange Act of 1934 as amended (48 Stat. 881, 15 U.S.C. Section 78a et seq.), the Securities Exchange Commission's Rules and Regulations 17 C.F.R. (Code of Federal Regulations) 240 et seq. and the New York Uniform Commercial Code are set forth in the Appendix, infra.

Questions Presented

1. Whether a plaintiff which receives a pledge of stock as collateral for a loan is a buyer of securities within the meaning of Section 3(a)(13) of the Securities Exchange Act of 1934 for purposes of a civil damage action under Section 10(b) and Rule 10b-5 promulgated thereunder?

2. Whether the requirements of Section 10(b) and Rule 10b-5 that a fraud to be actionable under the Securities Exchange Act be committed "in connection with the purchase or sale of any security" is satisfied where the alleged

"sale" is the release of collateral by a commercial bank of pledged stock upon repayment of its loan, and the alleged "purchase" is the pledge of the shares by a third party to the unknown plaintiffs?

Statement of the Case

This action was instituted by Samuel Mallis (hereinafter "Mallis") and Franklyn Kupferman (hereinafter "Kupferman") alleging *inter alia* that Bankers Trust Company (hereinafter "Bankers Trust") was prohibited by the 1933 Securities Act from receiving a pledge of securities from Jerome and Judith Kates (hereinafter "the Kates") in August 1970 as collateral for a loan and that by virtue of the Securities Act, Bankers Trust was prohibited "from disposing of the aforesaid securities, except to redeliver the same to the said Jerome Kates or Judith Kates, or the issuer" (A.11). The complaint further alleged that Bankers Trust transferred the securities to plaintiffs or their nominee in violation of the 1933 Act for which Bankers Trust received from another bank, Franklin National Bank (hereinafter "FNB"), the sum of $45,000 as part of the proceeds of a loan by FNB to Mallis and Kupferman (A.11). The courts below treated the complaint and subsequent affidavits as a 10(b) and Rule 10b-5 action under the 1934 Securities Exchange Act (A.135-136, 158, 162).

After an answer had been filed by Bankers Trust (A.50-52) and on motion to dismiss (A.124), the United States District Court granted the motion to dismiss, since the plaintiffs were not "purchasers" within the requirements of the *Birnbaum* doctrine as adopted in *Blue Chip Stamps* v. *Manor Drug Stores* (A.134). Although recognizing that under *Blue Chip Stamps* the plaintiff must be either a purchaser or seller, the court of appeals reversed and held that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165).

A. The Underlying Facts

The motion to dismiss was made six months after the filing of the complaint and the intervening affidavits and documents attached thereto were construed by the District Court as having augmented the complaint for purposes of this proceeding. The facts are well set forth in the opinion of the District Court (A.128-137) and in the opinion of Mr. Justice Nadel of the State Supreme Court (A.88-90).

1. The Bank's Loan and the Pledge of the Collateral.

Bankers Trust is a commercial bank regulated by the New York State Banking Department and the Federal Reserve Board. As such, it makes loans based on criteria of creditworthiness, whether such loans are secured or unsecured.

In August, 1970, Kates, who is not a party to this action, applied to Bankers Trust for a $50,000 loan (A.56, 102). As collateral, he pledged to Bankers Trust 40,384 shares of stock of Equity National Industries, Inc. (hereinafter "Equity National") belonging to both himself and his wife (A.56).

At the time Bankers Trust accepted the collateral as security for the loan, Bankers Trust believed the shares of stock to be valuable and received an opinion letter from counsel that the shares of stock delivered to Bankers Trust as collateral by Mr. & Mrs. Kates "although bearing the usual restrictive legend covering unregistered securities, will become eligible for public sale without registration after 6 months from the date of closing on August 7, 1970" (App. 50, A.56-57).[2] At that time, everyone expected the loan to be repaid to Bankers Trust by Kates and the collateral returned to Kates.

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[2] The opinion letter is part of the record in the pending State Court actions and is reproduced infra (App. 47-50).

Kates reduced his indebtedness to Bankers from $50,000 to $45,000 by making monthly payments (A.57). By letter of March 1, 1971, Equity National notified Bankers Trust that the earnings requirements had not been met for 1970 and requested that the shares issued to the Kateses, some of which had been pledged to Bankers Trust, be returned to Equity National for cancellation (A.96-100, 105). Bankers Trust was contacted by Kateses' attorney, who informed Bankers Trust[2] (App. 51-52):

> "• • • we have advised our clients that notwithstanding any controversy between Equity and them respecting the conditions of issuance of the Securities, since they delivered them to you as collateral for the loan, they have every right to expect you to return the Securities to them upon repayment of the loan.
>
> This letter is intended to advise you that our clients will hold you fully responsible for any damages which may be sustained by them in the event you fail to return the Securities to them at such time as your loan to Mr. Kates has been repaid."

As a result of the conflicting correspondence, Bankers Trust's attorney advised Equity National's attorney that the aforementioned shares of stock "were delivered to the Bank by Jerome B. Kates as collateral security for loans made to him and will be returned to him only when said loans are repaid". The letter went on to say (A.105, App. 53):

> "Bankers Trust Company does not intend to get into any dispute that you may have concerning his right to the said shares of stock.

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[2] These documents were part of the proceedings in the State Court.

> Moreover, the Bank has been put on written notice by the attorneys representing Mr. Kates, not to release the said collateral upon penalty of damages. If your client is disposed to furnishing the Bank with an Indemnity bond to fully protect the Bank in this matter, we will consider your client's demand. Otherwise, you may consider this letter as a rejection."[4]

Bankers Trust did not hear anything further from Equity until March 10, 1972, one week after it had returned the certificates of stock to the Kateses.

2. The Return of the Collateral to the Kateses.

Bankers Trust was informed by Kates that he sought to redeem his stock and that he had obtained a purchaser for the Equity National shares (A.59).

A closing was held at the offices of the Attorneys for Bankers Trust on March 3, 1972. Present at the closing were Kates, John B. Fowler, Jr., a stockbroker, Jack J. Arnold, an attorney, and John A. Murfitt, an Assistant Vice President of FNB (A.59). Murfitt was present as the representative of FNB (A.18).[5] Mallis conceded in the State Court proceeding that he "personally had no contact with the knowing defendants [including Bankers Trust]" (A.77).

The office of the Bank's attorney was utilized merely "as a facility to accommodate the parties involved. [Bankers

[4] This is part of the record in the State Court proceeding, reproduced infra, App. 53.

[5] Although the brief in opposition attempted to characterize Murfitt as Mallis' agent, this is contrary to Mallis' affidavit that "Murfitt in behalf of Franklin, attended" (A.18). Mallis had previously testified in the State Court action that Murfitt "didn't represent me" and he thought that he was represented by his attorney Jack Arnold. Indeed, Mallis had instituted a cause of action in malpractice against his attorney Jack Arnold (A.72-73. See also p. A74).

Trust's attorney] did not know and was never told the name of the purchaser, nor was [he] interested." (A.59). The attorney "merely stood on the 'sidelines' during the closing . . ." (A.59-60). See A.75-76 where Mallis swears that Bankers and its attorney remained silent.

The stock certificates were exhibited at the closing. The certificates bore a legend in bold type which declared the stock subject to an Escrow Agreement, and restricted transfer in accordance with the terms of the agreement (A.88-89, 60, 86, 32-39). Arnold asked for and received an affidavit from Kates to the effect that the legend in no way restricted the transfer of shares and that the "particular shares involved have been released from the Escrow Agreement" (A.84, 59, 60, 79, 86).

The FNB representative delivered the checks to Kates, including one check in the amount of $45,000 payable to Kates and Bankers Trust (A.60, 102-103). Bankers Trust's attorney refused to accept these checks since Bankers Trust "was not a party to the transaction involved" (A.60, 102-103). Bankers Trust's attorney insisted that the name of Bankers Trust as co-payee be stricken from the check (A.60-61, 102-103). This was done and the check was issued by FNB to Kates (A.60, 103). Kates then endorsed the check over to Bankers Trust (A.60, 27); whereupon Bankers Trust in accordance with Section 9-506 of the Uniform Commercial Code released and returned to Kates the previously pledged stock certificates (A.106). Bankers Trust applied the monies to a repayment of the loans made by Kates and considered the matter closed on March 3, 1972.

One week later on March 10, 1972, Bankers Trust was served for the first time with a complaint by Equity National to obtain a cancellation of the certificates of stock (A.105).[6] This action was discontinued against Bankers

[6] *Equity National Industries, Inc.* v. *Jerome B. Kates, et al.* including *Bankers Trust* (S.D.N.Y. 72 Civ. 503).

Trust (A.105). This lawsuit was the beginning of a series of lawsuits which subsequently made Bankers Trust aware for the first time of the transactions between Kates, Arnold and Fowler on one side and Mallis and Kupferman on the other.

3. The Transactions Between Mallis and Kupferman, and Kates, Arnold and Fowler to Which Bankers Trust Was Not a Party.

Prior to the closing on March 3, 1972, the negotiations between the plaintiffs Mallis and Kupferman and Arnold, Fowler and Kates had been completed. Bankers Trust is not alleged to have had knowledge of either the negotiations or the substance of the agreement. The closing was merely a formal ritual.

The parties to the transaction were Kates, Mallis, his brother-in-law Kupferman, Jack J. Arnold (hereinafter "Arnold") and John B. Fowler, Jr. (hereinafter "Fowler").

Mallis is a sophisticated and successful dentist. During the early 1970's, he speculated in various financial ventures. When the matter did not succeed, he resorted to both the State and Federal courts as in this case.[1]

Arnold was an attorney who has represented Mallis on prior occasions and had dealt with him as an entrepreneur (A.107-108, 64, 72-73). Fowler was a stockbroker and an officer of J. S. Love & Co. (A.16, 64).

On February 24, 1972, a week before the closing, the Kateses and Arnold entered into an agreement whereby the

[1] In another action, *Mallis* v. *Roggen and Layne* (E.D.N.Y. 74 Civ. 1610) Mallis is suing under Section 10(b) and Rule 10b-5 to recover monies allegedly lost by Mallis, "his family and friends" in a private placement of securities in late 1969 when the "plaintiff Samuel Mallis . . . passed the information that (the defendants) had given to him, to his family and friends, to induce them to purchase the aforesaid units in Designare."

Kateses assigned all of their right, title and interest to the stock for $4.50 a share or a total of $181,728 (A.23-25). In that agreement, Kates represented and warranted to Arnold that the Equity National stock was "validly issued, duly authorized, and outstanding on the books of Equity National Industries, Inc." (A.24). At the time of the agreement, Arnold made a $25,000 partial payment to the Kateses (A.23). Simultaneously, Kates gave Arnold an option to purchase "110,000 shares of common stock of Merck & Co., Inc. at sixty (60%) percent of the then existing market price to be determined by computing the preceding five days average closing price" (A.82).

On March 1, 1972, Arnold contacted Mallis and informed him that he had already advanced $25,000 to purchase the stock and that he needed an additional $156,000 to complete the purchase or the deposit would be forfeited (A.16, 107). Arnold told Mallis that although the securities were unregistered, the securities would soon become marketable by virtue of a new Regulation promulgated by the Securities and Exchange Commission (A.130, 16, 108). Arnold further told Mallis that the market value of the stock was between $10-13 per share which was "several times the purchase price of $181,000" or "at least $400,000" (A.16, 108, 130). Arnold persuaded Mallis and Kupferman to make a short-term loan of $156,000 to Arnold and Fowler (A.16, 108). Mallis and Kupferman contacted FNB which advised them that the transaction appeared to be in order and "recommended that plaintiffs become the borrowers so as to facilitate Franklin's advancement of the funds as required by Arnold, Fowler and Love & Co." (A.18, 17, 108). On March 3, 1972, Mallis and Kupferman executed the necessary documents whereby they borrowed the money from FNB. As noted by Judge Pollack, Mallis and Kupferman then proceeded to make a short term loan to Arnold and Fowler of $156,000 for which Mallis and Kupferman were to receive interest of $50,000 for thirty days (A.130, 156, 49, 108, 56).

Arnold, by letter of March 3, 1972, agreed that the Equity National shares were "to be held as collateral by Mallis" for this loan and pointed out (A.49):

> "There is currently pending a transfer pursuant to a written option a block of 100,000 shares of Merck & Co., out of which proceeds you will be reimbursed for the total sum of monies accruing to you. This transfer will be completed during March, 1972."

Arnold did not repay the moneys within the agreed upon 30 days. Instead of the $206,000 which he had contracted to receive, Mallis only recovered $50,000. Mallis claims that he is entitled to recover not only the unpaid balance of $106,000 on the moneys loaned to Arnold and Fowler, but also the $50,000 "finders fee" for a total balance still claimed by Mallis of $156,000 (A.71, 72, 80, 19).[8]

B. Judicial Proceedings

Subsequent to this time, Mallis instituted lawsuits against Bankers Trust in both State and Federal Courts, and Kupferman joined him in the Federal Court.

1. The State Court Proceeding

On December 11, 1972, Mallis instituted an action against Bankers as well as other defendants in the state court charging Bankers with both fraud and negligence in permitting "escrowed stock" to be delivered to the possession of Kates "by its silent acquiescence" thereby allegedly aiding and abetting a fraudulent transaction (A.63-76, 68-69, 74-75).

At the same time he brought actions against (1) Arnold and Fowler claiming a breach of contract (A.71-72); (2) Arnold claiming malpractice (A.72-73); and (3) the

[8] At the time of filing the complaint in this action, they still had not repaid the monies owing to FNB (A.18-19).

Kateses and their attorney claiming fraudulent concealment of facts (A.73-74). In dismissing the complaint against Bankers Trust, the court ruled (A.89-90):

> "The leading case on where there is a duty to speak is Amend v. Hurley, 293 N.Y. 587, which holds that barring a fiduciary or confidential relationship there is no duty to speak. Plaintiff had absolutely *no* relationship with defendants London, Bankers Trust or Equity National. He was not even a purchaser of the shares, according to his letter arrangement with Arnold. No matter what he chooses to call his participation in this 'investment', the Equity shares are called 'collateral' and he is guaranteed *repayment* out of another stock transaction.
>
> The 'fraudulent concealment' he alleges against these defendants must fall on the basis of plaintiff's own exhibits in opposition to these motions. The legend showing a restriction on the sale or hypothecation of the shares appears on the face and back of both stock certificates. The court is unable to determine when or how plaintiff could or should have been informed by these defendants, who could not and did not know of his existence prior to the closing which he did not attend."

An order of dismissal was entered (A.91-92) and no appeal was taken.[9]

[9] The state court action against Arnold, Fowler and the Kateses is still pending. Soon after the dismissal, Arnold issued a third-party complaint against Bankers Trust seeking judgment over if Mallis should recover against Arnold in the State Court proceeding. In August, 1975, Arnold, who was being sued for malpractice, sought and was ultimately granted leave to amend his third-party complaint against Bankers Trust (*Mallis* v. *Kates*, 52 A.D.2d 303, 383 N.Y.S. 2d 26, 27 (1st Dept., 1976)). Fowler likewise instituted a third-party complaint seeking indemnity from Bankers Trust. The State Court denied the motions to

(footnote continued on following page)

2. The District Court Decision

In February, 1975, Mallis and Kupferman instituted this action alleging that Bankers Trust had violated the Act by transferring the securities to the plaintiff—apparently through Kates paying off the loan and selling the securities to Arnold and Fowler, who then pledged the securities to plaintiff—in order to recover $45,000 (A. 10-11). They also claimed that they had no obligation to repay their loan from FNB because the transaction violated Regulation U, 12 C.F.R. 221 promulgated under Section 7 of the 1934 Act, 15 U.S.C. Section 78g, and sought the return of all moneys paid to FNB for principal and interest (A.6-9, 12). The court dismissed the claim against Bankers for failure to state a claim upon which relief can be granted and for lack of jurisdiction over the subject matter of the controversy (A.137). The court reasoned that the claim was barred to (A.134):

> "plaintiffs who were not purchasers within the requirement of the *Birnbaum* doctrine. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), as adopted in *Blue Chip Stamps* v. *Manor Drug Stores*, 43 U.S.L.W. 4707 (June 9, 1975), —— U.S. —— (1975)."

The court also held that plaintiffs could not invoke Regulation U to avoid their obligation to FNB since "no purchase or sale was involved." (A.134)

3. The Court of Appeals Decision

On appeal, the court of appeals affirmed the holding of the district court that Mallis and Kupferman were

(footnote continued from preceding page)

dismiss the third-party complaints on the pleadings, setting forth that it would seem more economical "to have one trial at which the rights of all the parties arising out of these inter-related transactions can be adjudicated." *Mallis* v. *Kates*, —— A.D. 2d ——, 393 N.Y.S. 2d 18, 19-20 (1st Dept. 1977). Cf. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 738, n.9.

obligated to repay their loan from FNB since they were neither "purchasing" nor "carrying" stock within the meaning of Regulation U. (A.161).

As to Bankers Trust, the court of appeals reversed and held Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165). Accordingly, the court of appeals found that Mallis and Kupferman had standing to sue.

The court did not explain how the same pledge of stock from Arnold and Fowler to Mallis and Kupferman was not a "purchase" for purposes of a Regulation U claim under Section 7g (15 U.S.C. Section 78g), but was a "purchase" for purposes of a claim under Section 10(b) and Rule 10b-5.

Summary of Argument

The 1934 Securities Exchange Act was not intended to federalize all transactions in securities and to include within it all persons and every allegation of fraud traditionally relegated to state law, *Santa Fe Industries Inc.* v. *Green*, 430 U.S. ——, 97 S. Ct. 1292, 1302-1304. To be actionable under Section 10(b) and Rule 10b-5 of the 1934 Act, not only must the complaint allege fraud but it must allege (1) a "purchase or sale" of a security by the plaintiffs and (2) the alleged fraud must be "in connection with" the purchase or sale (15 U.S.C. Section 78j). The instant complaint did not satisfy each of these requirements. The plaintiffs Mallis and Kupferman were not purchasers but lenders; and Bankers Trust was not a party to the transaction but merely released its collateral to its debtor upon repayment of an outstanding indebtedness.

1. The court of appeals erroneously concluded that the purchaser-seller requirement was satisfied whenever there

was a pledge transaction. This holding is contrary to *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, the plain language of the Act, and the legislative history. Sections 3(a)(13) and (14) define the terms "buy" and "purchase" and "sale" and "sell" for purposes of the 1934 Act. 15 U.S.C. Sections 78c(a)(13) and (14). Neither definition includes a pledge. Both at common law and under the Uniform Commercial Code, a "pledge" of securities is not a "purchase" or "sale", but merely the delivery of a security interest in the collateral. Upon repayment, the pledgee has the duty to return the collateral to the debtor-pledgor. Congress had recognized this distinction. Thus, when Congress wanted to include a "pledge" within the statutory definition of "sale", it did so. See Public Utility Holding Company Act, 15 U.S.C. Section 79b(a)(23).

2. Nor did the release of the pledged stock to the Kateses upon repayment of the indebtedness subject Bankers Trust to a civil action under Section 10(b) and Rule 10b-5. *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490 (C.A. 5). Federal legislation was not needed for privately negotiated pledge transactions between borrowers and lenders. 1 Loss, *Securities Regulation* (2d ed. 1961) 649. All rights and remedies between the two could be resolved by state law. The Securities Exchange Act should not be expanded to include all banking transactions cognizable under state law merely because the indebtedness had been collateralized by stock. Such an expansion would burden both the Federal Courts and the banks, whenever disgruntled borrowers seek to institute such proceedings to avoid and delay payment of an outstanding indebtedness. *Blue Chip Stamps*, 421 U.S. at 740.

3. Bankers Trust's release of the securities to the Kateses was not "in connection with" the pledge of securities to the plaintiffs. Mallis and Kupferman made no inquiries of Bankers Trust. The loan agreement had been

fully completed prior to the closing not attended by Mallis and Kupferman. Mallis and Kupferman did not look to the Equity National stock for repayment of the loan, but to another transaction. The factual matrix demonstrates that there was no "connection" between the pledge of stock to Mallis and Kupferman and Bankers Trust.

ARGUMENT

Introduction

To fall within the scope of Section 10(b) of the Securities Exchange Act and Rule 10b-5, the fraud alleged by the plaintiff must be "in connection with the purchase or sale of any security" (15 U.S.C. Section 78j). This Court has held that only a purchaser or seller of a security may maintain a private cause of action "in connection with the purchase or sale of securities" for damages suffered under Section 10(b) of the Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 733; *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U.S. 6, 12-13. For a complaint to be actionable under the Securities Exchange Act, not only must the complaint allege fraudulent conduct, but also must allege (1) the purchase or sale of a security, and (2) a nexus between the alleged fraud and the transaction. These two elements were plainly not satisfied in this case and Judge Pollack rightly dismissed the complaint for lack of standing.

The court of appeals erroneously, we submit, attempted to limit this Court's decision in *Blue Chip Stamps* by holding that on the facts of this case, there were "both a 'sale' and a 'purchase'" cognizable under Section 10(b) of the 1934 Act. The court of appeals concluded that Mallis and Kupferman "were purchasers by virtue of their acceptance of the pledge by Arnold and Fowler; and Bankers Trust was a seller by virtue of its release of the Kateses' pledge" (A.165). This conclusion ignores the fact that the

two transactions were separate and distinct. The return of the collateral by Bankers Trust to Kates was one transaction. The pledge by Arnold and Fowler to Mallis was a completely separate transaction of which Bankers Trust was not aware until after the institution of these lawsuits. In combining the two transactions to justify a cause of action, the court of appeals ignored *Blue Chip Stamps* and held, as did the dissent therein, that "a remedy exists under Rule 10b-5 whenever there is a 'logical nexus between the alleged fraud and the sale or purchase of a security'" (421 U.S. at 736 n.8)

I. Mallis and Kupferman clearly lack standing to maintain a cause of action against Bankers Trust under the Securities Exchange Act of 1934 since as pledgees they were plainly not purchasers or sellers of securities as required by this court in *Blue Chip Stamps*.

The court of appeals erroneously held that the purchaser-seller requirement of Section 10(b) and Rule 10b-5 was satisfied whenever there was a pledge transaction (A.162-165). This holding is contrary to the decision of this court in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975), the plain language of the statute, and the legislative history of the Act.

As "made clear" by this Court in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. ——, 97 S.Ct. 1292, 1300, "in deciding whether a complaint states a cause of action for 'fraud' under Rule 10b-5, we turn first to the language of Section 10b-5 for '[t]he starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197, *Blue Chip Stamps, supra*, at 756 (Powell, J. concurring).

For purposes of the 1934 Act, Congress defined the terms "buy" and "purchase" and "sale" and "sell". Section

3(a)(13) of the Securities Exchange Act of 1934 defines "buy" and "purchase" to "include any contract to buy, purchase or otherwise acquire" (15 U.S.C. Section 78c (a)(13)). The terms "sale" and "sell" are defined to "include any contract to sell or otherwise dispose of" (15 U.S.C. Section 78c(a)(14)). Neither definition includes a pledge which is merely a security interest in collateral. Neither a pledge of stock nor its redemption brings the transaction within the "purchase" and "sale" requirements of Section 10(b) and Rule 10b-5.

A. The pledge of securities as collateral for an indebtedness is not a "purchase" or "sale" within the meaning of the 1934 Securities Exchange Act.

At common law, a pledge of securities occurs whenever a debtor physically delivers collateral to a secured party and the pledge is perfected when the collateral comes into the possession of the secured party. The goods are kept by the creditor until the debt is repaid. Legal title remains in the pledgor. Black's Law Dictionary, 1312 (4th Ed. 1957). The pledgee occupies a fiduciary relationship with the pledgor. *Easton* v. *German-American Bank*, 127 U.S. 532, 536-537 (1888). Upon default, the pledgee does not keep the property as payment of the debt, but merely has the right to sell the property to liquidate the debt and the excess proceeds from the sale must be remitted to the pledgor.

Article 9 of the Uniform Commercial Code as enacted in New York and most states has codified the law regulating secured transactions including a security interest in stock certificates. UCC Section 1-201(37) defines "security interest" to mean "an interest in personal property or fixtures which secures payment or performances of an obligation." The Official Comment to UCC Section 9-101 makes it clear that "the Article applies to all transactions intended to create security interest in personal property

and fixtures . . ." UCC Section 9-305 provides for the perfection of a security interest in stock certificates by possession and without the need for any filing.

The rights and duties of both the debtor-pledgor and the creditor-pledgee are carefully delineated. UCC Section 9-207 sets forth the standard of care to be followed in the preservation of the collateral when collateral is in the secured party's possession and the duty to use reasonable care in the custody and preservation of the rights of the debtor against all other parties.

New York Law clearly sets forth the obligation of parties in the event of default, including the debtor's right to "redeem the collateral by tendering fulfillment of all obligations secured by the collateral." (UCC Section 9-506). As at common law, "if the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus . . ." (UCC Section 9-502(2)). The secured party may only dispose of collateral by sale in a "commercially reasonable" manner and is required to apply the net proceeds to the satisfaction of the indebtedness (UCC Section 9-504(2)). If the pledgee-secured party does not act in accordance with these and the other prescribed standards, the debtor has the "right to recover from the secured party any loss . . ." (UCC Section 9-507(1)).

There has been nothing since the enactment of the 1934 Securities Exchange Act to change the common law definition of a pledge as a mere security interest and not a "sale" or transfer of title in property.

B. Mallis and Kupferman clearly lack standing to maintain an action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 since, as pledgees, they were not purc[illegible]rs or sellers of securities as required by *Blue Chip Stam*

This Court has held that only a purchaser or seller of a security may maintain an action for damages under

Section 10(b) of Securities Exchange Act and Rule 10b-5. *Blue Chip Stamps, supra.*

Congress specifically defined the terms "buy" and "purchase" and "sale" or "sell" for purposes of that Act. Congress did not follow the definitions in the 1933 Securities Act but narrowed the definitions."

As we have shown *supra*, a pledge of stock, both at common law and under the Uniform Commercial Code, is not a sale of securities, but merely the delivery of a "security interest" in collateral to a creditor. The underlying obligation continues to be either a note or a contract. The ultimate interest in the securities pledged as collateral remains in the pledgor since the pledgee must act with due diligence (UCC Section 9-207). The pledgor retains the right of redemption at any time and the pledgee is obligated to remit to the pledgor any receipts in excess of the obligation. See generally Sections 9-504 to 9-506 of the Uniform Commerical Code, discussed *supra*.

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[10] See *Blue Chip Stamps, supra*, 421 U.S. at 750-751, n.13, where this Court noted:

"These provisions as enacted starkly contrast with the wording of the bill which became the 1934 Act when it emerged from committee and was presented on the Senate floor by Senator Fletcher, the chairman of the Senate Committee on Banking and Finance. See S. 2693, 73d Cong., 2d Sess. (1934). Section 3(11) of the bill as presented to the Senate provided:

"The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire contract of purchase, *attempt or offer to acquire or solicitation of any offer to sell a security or any interest in a security.*" (Emphasis added)

And Section 3(12) of the bill provided:

"The terms 'sale' and 'sell' each include any contract of sale or disposition of, contract to sell or dispose of, *attempt or offer to dispose of, or solicitation of an offer to buy a security or any interest therein.*" (Emphasis added)

During consideration of the bill on the Senate floor, the ambit of these provisions was narrowed through amendment into the present wording of §§ 3(a)(13) and (14). 48 Stat. 884 • • •"

As the pledgor is not a seller, similarly the pledgee, who receives corporate securities as security for a loan is not a purchaser within the statutory definition.

When Congress wanted to include a "pledge" within the definition of "sale" it did so. Thus in the Public Utility Holding Company Act, Congress defined "sale" or "sell" to include "any sale, disposition by lease, exchange or pledge, or other disposition." 15 U.S.C. Section 79b (a)(23). In this case by not including "a pledge" within the statutory definition of the 1934 Act, Congress did not intend to include a pledge for purposes of a civil damage action under Section 10(b) or Rule 10b-5 of the 1934 Securities and Exchange Act.[11]

See *McClure* v. *First National Bank of Lubbock,* 497 F.2d 490 (CA 5 1974) *cert. denied* 420 U.S. 930 (1975). In that case, the plaintiff sued a bank and its loan officer on a securities fraud theory in connection with a stock transaction which arose when, as part of a loan, the bank required plaintiff to pledge her stock as collateral. Thereafter, the bank foreclosed on the loan and liquidated the

[11] The District Court stated in *McClure* v. *First National Bank of Lubbock,* 352 F. Supp. 454, 458 (N.D. Texas 1973); "It is significant that Congress has in effect found, by the passage of the Truth in Lending Act, 15 U.S.C. § 1601 et seq., that the Securities Exchange Act of 1934 is inapplicable to consumer loans, and, by strong implication, to commercial loans as well. Congress apparently felt it necessary to curb abuses in consumer loans by the passage of a new statute, thus implying that such abuses could not be reached by the Securities Exchange Act of 1934. And in 15 U.S.C. § 1603, a section within the Truth in Lending Act, Congress in setting forth transactions outside the purview of the Truth in Lending Act lists 'credit transactions . . . for business or commercial purposes' and 'transactions in securities' as two different types of transactions. Thus it is clear that most, if not all, ordinary commercial loans are not 'securities' as defined by Congress as recently as 1968. Should Congress wish to place such commercial loans under federal regulation, it need only enact a statute similar in form to the Truth in Lending Act. It is not within the proper province of this Court to extend the scope of the Securities Exchange Act of 1934 beyond the point where Congress has chosen to act."

assets of the corporation rendering plaintiff's stock worthless.

The District Court dismissed the complaint on the grounds of lack of subject matter jurisdiction. The Court of Appeals affirmed the lower court's ruling that the transaction did not fall within the federal securities laws.

As in *McClure supra,* Judge Pollack noted "there was no purchase by plaintiffs in this case. Plaintiffs loaned the funds to Arnold and Fowler, • • •. While the stock later came into plaintiffs' possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus. Attempts to characterize that transaction as a purchase of the stock by plaintiffs are not convincing" (A.134).

The underlying obligation between Mallis and Kupferman and Arnold and Fowler was not the purchase of the Equity National stock, but the agreement between them whereby Mallis and Kupferman were to make "a short term loan" of $156,000 to Arnold and Fowler for which they were to receive $50,000 in interest[12] within thirty (30) days (A.156, 16, 49). The Equity National stock was collateral for the entire transaction. Moreover, by their own allegations, Mallis and Kupferman did not expect to be repaid from the Equity National stock, but from the proceeds of another transaction (A.49). Mallis and Kupferman

[12] $50,000 interest for a thirty (30) day use of money is arithmetically computed to be an interest rate of 383%. Regardless of whether Mallis and Kupferman called the $50,000 "profit" "bonus" "finders' fee" or "plain interest", $50,000 to be received for a short term thirty day loan of $156,000 is usurious interest. See *Durst* v. *Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, 354 (1st Dep't 1964), affirmed 17 N.Y. 2d 445, 266 N.Y.S.2d 806 (1965) where now Chief Judge Breitel ruled that a purported stock sale transaction could be a disguise for a usurious loan agreement, "regardless of the form". See also *Schwartz* v. *Userowitz,* 56 Misc. 2d 1016, 290 N.Y.S.2d 12 (S.Ct. N.Y. 1968) affirmed 31 A.D. 2d 1010, 299 N.Y.S.2d 781 (1st Dep't, 1969) all monies exacted as "interest" or "bonus" were subject to the usury laws.

clearly did not enter into "a contract to buy, purchase or otherwise acquire" securities as required by the Act (15 U.S.C. Section 78c(a)(13)).

Mallis and Kupferman merely acquired a security interest in the stock which, under New York law in any event, was rendered totally unenforceable by virtue of their participation in a usurious contract when they charged 383% interest. This was plainly in excess of the rate allowed under Section 5-501 of the N.Y. General Obligations Law.

Section 190.40 of the N. Y. Penal Law declares criminally usurious interest, "at a rate exceeding twenty-five percentum per annum . . .". Section 5-511 of the N. Y. General Obligations Law voids and renders unenforceable the usurious contract.[13]

Totally ignoring the language of the 1934 Act, and the fact that Mallis and Kupferman, as pledgees, merely had a security interest in the collateral subject to divestment, the court of appeals erroneously relied on two of its earlier decisions construing the 1933 Securities Act to expand liability under Section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act, *United States* v. *Gentile,* 530 F.2d 461 (C.A.2, 1976) cert. denied 426 U.S. 936 (1976), *SEC* v. *Guild Films,* 279 F.2d 485 (C.A.2, 1960) cert. denied sub nom. *Santa Monica Bank* v. *SEC,* 364 U.S. 819, which had previously stated that all pledges were sales. *Guild*

[13] Section 5-511(2) of the N.Y. General Obligations Law further provides that where, as here, a pledge "has been taken or received; in violation . . . of the (usury) provisions, the court shall declare the same to be void and order the pledge to be surrendered and cancelled." Certainly Mallis and Kupferman did not by the acceptance of the pledge, purchase the Equity securities, but obtained a security interest rendered void by virtue of the fact that they had entered into a plainly usurious agreement, and under New York Law, the Courts would require them to surrender and return the pledged stock certificates to Arnold and Fowler. See *Curtiss* v. *Teller,* 157 App. Div. 804, 143 N.Y.S. 188 (4th Dep't, 1913). *Bowery Savings Bank* v. *Nirenstein,* 269 N.Y. 259, 263, 199 N.E. 211 (1935).

Films involved a scheme where a bank and its debtor agreed to liquidate unregistered securities as soon as the securities were received to satisfy an outstanding indebtedness. The court held the pledge to be a sale and the bank an underwriter within the meaning of the 1933 Act. In *Gentile,* the Second Circuit held that a pledge of fraudulent securities to borrow moneys was a sufficient sale of securities to subject the fraudulent pledgor to criminal violations. The pledgor there had issued unauthorized certificates in his own name and either sold them on the over the counter market or pledged them to banks as collateral for loans which they had no intention of repaying (530 F.2d at 464). In that context, the court held that the pledge of securities was a sale relying on the *Guild Films* decision, and disagreeing with the Fifth Circuit decision in *McClure* (530 F.2d at 466-467). Both cases arose under the 1933 Securities Act and rely on the broader definition of "purchase" and "sale" in that Act, rather than the more narrow definition in the 1934 Act. See *Blue Chip Stamps supra* at 733, n.5. Unlike the instant civil action, both cases involved the enforcement of the Securities laws, whether injunctive relief in *Guild Films supra* or criminal proceeding in *Gentile supra. Guild Films* has been broadly criticized by the commentators as wrongly decided. See 1 Loss, *Securities Regulation* 2d Ed. 1961, 645-649, Pierce, *Securities and Exchange Commission* v. *Guild Films Co.,* 1961 Business Lawyer April, 604.

Although we do not believe a pledge is a "purchase" or "sale" for purposes of the 1933 Securities Act, it plainly was not intended to be a "purchase" or "sale" for

[14] Mr. Justice Goldberg in *SEC* v. *Capital Gains,* 375 U.S. 180, 193 noted, "it is not necessary in a suit for equitable relief to establish all the relevant requirements as in a suit for money damages." See also *Blue Chip Stamps Inc.,* 421 U.S. at 751, n.14 where this Court stated "Our decision in *SEC* v. *National Industries,* 393 U.S. 453 (1969), established that the 'purchaser-seller rule imposes no limitations on the standing of the SEC to bring an action for injunctive relief under § 10(b) and Rule 10(b)(5).'"

purposes of a civil action under the 1934 Securities Exchange Act. As Professor Loss points out, "federal legislation was hardly needed for privately negotiated pledge transactions between borrowers and lenders." 1 Loss, *Securities Regulation* (2d Ed. 1961) 649.

The Rules of the Securities and Exchange Commission under the 1934 Act recognize that a pledge of securities is not a sale. See Rule 16-a-6, 17 C.F.R. Section 240.16a-6(2) which requires that the pledgor, not the pledgee, make the requisite filings reflecting "change in beneficial ownership."

Similarly during the 27 years between the passage of the Securities Act of 1933 and the second circuit's decision in *Guild Films,* the SEC took the position that a bona fide pledge was not the distribution of securities, and registration was unnecessary.[15]

In reaching its conclusion, the Commission had followed the views of two early General Counsels of the Commission[16], Throop and Lane "Some Problems of Exemption

[15] See in *F.L. Jacobs Co.* v. *Inland Credit Corp.*, 57-61 CCH Federal Securities Law Reporter, paragraph 90,908 (S.D.N.Y. 1959) a suit seeking to void a loan transaction and to enjoin the defendant from exercising the right to enforce an agreement by the sale of plaintiff's collateral security in a corporation. Judge Edelstein ruled: "• • • There is doubt on the question of whether or not this collateral is 'security' under § 2(1) of the Securities Act of 1933 inasmuch as the sale of it can hardly be said to put into the hands of the public anything representing the advance of money upon which they may hope to receive earnings. There is, further, doubt on the issue of whether or not a sale of collateral by a bona fide pledgee (and there is nothing in this record to indicate that the defendant is anything but a bona fide pledgee) can result in any liability to the pledgor or pledgee. No reported cases on this point have been discovered by the court or cited by counsel, but the affirmative of the proposition seems highly tenuous, the more so because of the absence of precedent in the context of long settled commercial practices."

[16] Note, "The Exception Status Of The Bona Fide Pledgee of Unregistered Securities Under the Securities Act of 1933," 1960 Duke Law Journal 638, at 641, n.10.

under the Securities Act of 1933," 4 Law and Contemporary Problems 89, 124-125, Note 103.

When *Guild Films* was handed down, the SEC, although it continued to recognize that a bona fide pledge of collateral in good faith was exempt from the distribution requirements[17], changed its position to hold that the pledge of unregistered stock as loan collateral becomes a "sale" only if the pledgee accepts the securities with the knowledge that it is going to foreclose on the securities and to distribute the securities to the public at large. Professor Loss pointed out (1 Loss ibid. at 645) that the status of the foreclosure sales by pledgees "was unsettled by the Second Circuit decision of May, 1960 in the *Guild Films* case." Until then it had been generally considered that "a bona fide pledge [as here where it had taken *place two years before*] *did not involve* an 'offer' or 'sale' and that, in any event, a foreclosure sale by a bona fide pledgee of securities deposited as collateral • • • was exempt" under the law (Loss, ibid.). Despite its position with respect to registration requirements and distribution under *Guild Films* the Securities and Exchange Commission has recognized that (Release No. 4669, Securities Act of 1933, February 17, 1964, Emphasis added):

> "Since a sale by the pledgee is for the purpose of fulfilling certain obligations of the pledgor, since the pledgee is obligated to remit to the pledgor receipts from such sale in excess of the amount of the obliga-

[17] In 73-74 CCH Federal Securities Law Reporter Paragraph 83,361, the Commission Staff stated: "It is anticipated that the Japanese Purchasers will pledge their shares to secure bank loans, the proceeds of which will be used to purchase the Company's stock. The lending institutions involved are permitted to dispose of the shares in the event that the Japanese Purchasers default on their repayment of the loans. You state that you do not consider the resale potential as a significant factor since the size and prominence of the Japanese Purchasers make it highly unlikely that they would default on their repayment obligations."

tion, and since *the pledgee, in effect, stands in the shoes of and acts for the pledgor in selling the collateral,* a broker may ordinarily effect sales as agent for both parties, if he takes into account other sales by the pledgor and his associates within the preceding six months, and otherwise complies with the rule."

To the same effect see *Great Southwestern Corp.*, 70-71 CCH Federal Securities Law Reporter, paragraph 78, 132 (April 13, 1971); *Air Reduction Company Incorporated,* 70-71 CCH Federal Securities Law Reporter, paragraph 78,101 (April 8, 1971). The conclusion by the court below that the pledge of the collateral by Arnold to Mallis and Kupferman is a sale is contrary to the plain language of the Act and common law and the SEC's recognition that at the time of the pledge, title does not pass to the pledgee, but the pledgee merely "stands in the shoes of" the pledgor, *supra.*

The Second Circuit attempted to limit the decision in *Blue Chip Stamps* and to stress the fact that the pledge to Mallis and Kupferman "is just as concrete a transaction as is a normal transfer of title." (A. 164). However, this court made it clear in *Blue Chip Stamps* that the term "sale" was not intended to apply to a "generalized event of public disposal of property, but was carefully drawn to define the term 'sale' for purposes of the Act" (421 U.S. at 733, n.5). A pledge plainly does not come within this definition. *Herpich* v. *Wallace,* 430 F.2d 792, 812 (CA 5, 1970) cited with approval by this Court in *Blue Chip Stamps,* 421 U.S. at 748.

C. The mere acceptance of a pledge of stock as collateral for a loan in 1970 and its subsequent release to the borrower upon the repayment of the loan in 1972, did not make Bankers Trust a "seller" of securities subject to a civil damage action under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

In holding that Bankers Trust was a "seller" of securities by virtue of its release of the collateral to the Kateses, the court of appeals compounded its error by deciding an issue totally unnecessary to its decision. As this court recognized in *Blue Chip Stamps,* the "purchase or sale" requirement of Section 10(b) and Rule 10b-5 is a purchase or sale by plaintiff—not by the defendant. In any event for the very same reasons *supra* that a pledge of stock by Arnold to Mallis and Kupferman was not a purchase, so the return of the pledged securities to the Kateses upon repayment of the indebtedness to Bankers Trust was not a sale.

As we have shown, *supra,* the pledge of stock both at common law and under the Uniform Commercial Code was not a sale of securities but merely the delivery of a "security interest" in the collateral to the creditor. The underlying obligation of Kates to Bankers Trust was a note, *not* the securities. Upon repayment of the indebtedness, Bankers Trust was required to return the collateral to the Kateses (U.C.C. Section 9-506). Such return to the pledgor did not bring the transaction within the purchase or sale requirements of Section 10(b) and Rule 10b-5.

The conclusion by the court below that Bankers Trust became a "seller" of the collateral when it returned the securities to the Kateses is contrary to the plain language of the Act, the common law and the SEC's recognition that the pledgor retains an interest in the securities, *supra.* The Kateses did not purchase the stock nor did they anticipate a purchase of their own stock when they repaid the

loan. They merely obtained that to which they were entitled. *See King* v. *Sharp*, 74-75 CCH Federal Securities Law Reporter paragraph 94,828 (Northern District, Texas May 1, 1974) where the court held that the Trustee in Bankruptcy was not a purchaser of securities to sustain standing in a 10(b) and 10b-5 action when the stock previously pledged as collateral had been released by a bank on repayment of the loan. *Cf. Bronner* v. *Goldman*, 361 F.2d 759, 762 (CA 1, 1966), where the court rejected the contention that an action under 10(b) could be brought against a factor who accepted securities as collateral, noting that "their business was lending money and not trading in securities."[18]

In lending money, Bankers Trust makes a credit decision, based on criteria of creditworthiness, whether such loans are secured or unsecured. Banks do not lend money with a view to placing a defaulted loan on their books. Collateral is taken as insurance against the unexpected event of default, just as a person insures his or her house against contingency of fire. *Pierce, "Securities and Exchange Commission* v. *Guild Films Co., Inc.".* 1961 Business Lawyer, April, 603-604.

Loans collateralized by stocks or bonds and regulated by state law are looked upon with favor by banks since the collateral is an additional assurance of repayment. The borrower often benefits from the lender's assurance by being able to obtain funds on more favorable terms then if the transaction were unsecured. These pledges are attractive to borrowers not only in connection with their other

[18] See also *First Trust and Savings Bank* v. *Fidelity Philadelphia Trust Co.*, 214 F.2d 320, 323 (CA 3, 1954), where the court held that a bank which takes documents as a bailment for its customer and then releases documents to a third party did not make the bank a seller within the terms of the Securities Act of 1933.

transactions, but also in connection with the need for funds for personal and business purposes."[19]

The commentators have noted from experience that the pledgee of securities "ordinarily acts on the belief that the odds are highly against his ever having to liquidate the loan by carrying out a sale of the securities so pledged. Indeed, few bankers would want to go into a transaction believing that they would probably have to carry out the sale of the underlying securities." *Vagts supra* at p. 1510. See also Pierce, *supra* at 604-606.

Bankers Trust made an ordinary commercial secured loan to the Kateses. It expected to be, and was, repaid by the debtor almost two years later. The occasion at which Bankers Trust returned the collateral, as required by state law, was a routine closing. The return of the stock to the pledgor upon repayment of the indebtedness does not bring the transaction within the purchase or sale requirement of Section 10(b) and Rule 10b-5. As reported in *McClure* v. *First National Bank of Lubbock, Texas, supra*, (497 F. 2d at 495, emphasis added):

> "• • • A commercial bank in accepting a pledge of stock as additional consideration for the extension of an overdue commercial loan does not necessarily affect the securities industry. A commercial bank's business is lending money not trading in securities. Cf. *Bronner* v. *Goldman*, 361 F.2d 759 (1st Cir.), cert. denied, 385 U.S. 933, 87 S.Ct. 295, 17 L.Ed.2d 214 (1966)

[19] *Coogan, Hogan & Vagts*, 1A Secured Transaction under the Uniform Commercial Code (Matthew Bender)—Vagts, "Pledges of Corporate Securities" at 1502. The importance of the pledge of stocks and bonds as collateral is represented by the survey conducted by the Federal Reserve System for the Special Study of Securities Markets on September 26, 1962, which concluded that "member banks of the Federal Reserve System had outstanding almost $11 Billion of loans wholly or partly collateralized by stocks or bonds".

(factor selling pledged stock not a 'broker' or 'dealer'). If the bank sells stock pledged as loan collateral, it might then be subjected to liability in connection with the sale if it does not meet the requirements of the anti-fraud provisions of the securities acts, *but mere acceptance of a stock pledge as collateral in a privately negotiated transaction between borrower and lender does not, of itself, bring within the scope of the federal securities acts a transaction otherwise outside their purview.* See 1 L.Loss, Securities Regulation 649 (2d ed. 1961)."

This reasoning is consistent with this Court's recent ruling in *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 157, where this Court noted the Securities Exchange Act of 1934, "was enacted primarily to halt securities fraud, not to regulate banks. Indeed, banks were specifically exempted from any provisions of the securities laws, and Congress almost contemporaneously enacted other specific legislation dealing with the problems arising from banks' involvement in the securities business. The passage of that legislation and the exemption of national banks from important provisions of the securities laws suggest, if anything, that Congress was reaffirming its view that national banks should be regulated separately by specific legislation applying only to them." This Court further noted in *Radzanower supra*, 426 U.S. at 155, n.11.

"The legislative history of the Securities Acts does not indicate that Congress considered banks as likely defendants in actions brought under those Acts. While Congress did examine problems stemming from the relationship of banks and the securities business in the early 1930's, see S.Rep. No. 1455, 73d Cong., 2d Sess. (1934) it dealt with those problems in comprehensive legislation dealing only with banks. See Banking Act of 1933, 48 Stat. 162. See generally *Investment Co. Institute* v. *Camp*, 401 U.S. 617."

In enacting the Banking Laws, Congress recognized the importance of preserving the financial integrity of banks and subjected the commercial banking business to extensive Federal and State regulation in order to protect the depositors. *United States* v. *Marine Bank Corp.*, 418 U.S. 502, 627, 632.

Aware of the peculiar problems and strength of banks resulting from regulation by state and federal banking authorities, Congress did not seek to make a wholesale application of the securities laws to banks, but instead made specific provisions applicable to banks with respect to the Securities Laws. When Congress concerned itself in the Securities Exchange Act of 1934 with the problems of speculative trading in securities, Congress provided that banks were to be regulated *not* by the Securities Exchange Commission, but by the Federal Reserve Board (15 U.S.C. Sec. 78g-78h).

If Congress in enacting the Securities Exchange Act had intended all transactions involving the pledge of stock to come within the Act and not be governed by state law, it would have said so. The mere fact that securities are involved in the transaction does not automatically bring the transaction within the standing requirements of Section 10(b) and Rule 10b-5 and permit the action to be brought in Federal Court. See *United Housing Foundation* v. *Foreman*, 421 U.S. 837, 849 (1975) footnote 14, where this Court reversed the Second Circuit's expanded and "literal approach" to the Act by noting the Fifth Circuit's decision in *McClure*. Certainly Congress did not intend to federalize the substantive law involving the pledge of stock as collateral merely because the transaction involved securities where, as here, "'the cause of action was one traditionally relegated to state law. . . .'" See *Piper* v. *Chris-Craft Industries, Inc.*, 97 S. Ct. 926, 929 quoting *Cort* v. *Ash*, 422 U.S. 66, 78, *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. ——, 97 S. Ct. 1292, 1303.

In enacting the Securities Exchange Act of 1934, Congress stated that its purpose was to provide for the regulation of "securities exchanges and over-the-counter markets" operating in interstate and foreign commerce and through the mails to prevent inequitable and unfair practices on such exchange. 15 U.S.C. § 78b, 48 Stat. 881 as amended. Congress did not intend to include ordinary commercial transactions involving stock under the umbrella of the act, especially as here where Congress did not expressly provide a private cause of action for violations of Section 10(b). *Santa Fe Industries* v. *Green, supra,* 97 S. Ct. at 1303, the plaintiffs and "others in [their] situation [should be relegated] to whatever remedy is created by state law."

Indeed if every case involving the pledge of securities would come within the Act, the Federal Courts would be burdened by a plethora of litigation involving the debtor and the bank when the loan goes bad and the debtor has pledged securities which are either sold or diminished in value as a result of shifts in the stock market.[20] In an attempt to stave off repayment, the disgruntled borrower-pledgor will institute frivolous actions in federal courts and utilize the extensive discovery available under federal law to harass and annoy the creditor. *Santa Fe Industries, supra,* 97 S. Ct. at 1303, *Blue Chip Stamps, supra,* 421 U.S. at 740. See for e.g. *Dopp* v. *Franklin National Bank,* 374 F. Supp. 904 (S.D.N.Y.) on remand from 461 F.2d 873 (CA 2, 1973) where, after the bank had obtained a judgment

[20] See *Brodheim* v. *Chase Manhattan Bank,* 75 Misc. 2d 394, 347 N.Y.S.2d 394 (Sup. Ct. N.Y. 1973); *American Bank and Trust Company* v. *Lichtenstein,* 45 A.D.2d 790, 369 N.Y.S.2d 155 (1st Dept. 1975); *Smith* v. *Security National Bank,* 175 N.Y.L.J. p. 7, col. 1, and *Grace* v. *Sterling Grace & Co.,* 30 A.D.2d 61, 289 N.Y.S.2d 632 (1st Dep't 1968); *Bankers Trust Company* v. *Ungar,* 387 N.Y.S.2d 813 (1st Dept. 1976); *Bankers Trust Company* v. *Bennett,* 387 N.Y.S.2d 813 (1st Dept. 1976).

against Dopp for non-payment of a note in state court, Dopp instituted an action under Section 10(b) and Rule 10b-5 to prevent Franklin from liquidating pledged collateral to satisfy the judgment. Only after much expensive litigation was the bank allowed to liquidate the collateral and satisfy the judgment, and the action was discontinued as against the bank.

II. Bankers Trust's release of a pledge of collateral to the original borrowers upon repayment of the indebtedness was not "in connection with" the loan transactions between plaintiffs and third parties.

There is still a second basis for ruling that the plaintiffs have failed to state an actionable claim under Section 10(b) and Rule 10b-5. Not only must the plaintiff be a purchaser or seller of securities, but the alleged fraud must be "in connection with" the purchase or sale. The factual matrix of this case plainly does not satisfy the "in connection with" requirement.

Despite the fact that there was and could be no allegation of a fraudulent act by Bankers Trust "in connection with" the pledge of the collateral from Arnold to Mallis and Kupferman, the court of appeals "badly strained" the language of the Act to permit a cause of action under the Securities Exchange Act merely because stock which had been pledged almost two years earlier as collateral in a commercial loan transaction, was redeemed by the pledgor, *i.e.* Kates, who sold it to a third-party, *i.e.* Arnold and Fowler, who then proceeded to pledge it as collateral to a fourth-party Mallis and Kupferman of whose existence Bankers Trust did not know. A plaintiff certainly does not have standing on the mere allegation that the defendant defrauded someone else, such as a third-party purchaser or seller in a separate transaction.

As we have shown *supra* pp. 27-33 Bankers Trust plainly did not sell the stock but merely returned the stock to the pledgor as it was obligated to do upon the repayment of the indebtedness. Similarly, as we have shown, *supra*, Mallis and Kupferman did not purchase the stock when they accepted the Equity National stock for collateral. Moreover, Mallis and Kupferman looked not to the Equity National stock for repayment, but to the proceeds of yet another transaction, *i.e.* the sale of "a block of 100,000 shares of Merck & Co., Inc." (A.49) another transaction of which Bankers Trust was not aware. Certainly, as noted by the State Supreme Court in holding that Mallis had no cause of action against Bankers Trust, since not only was he "not even a purchaser of the shares" but Bankers Trust "could not and did not know of his existence prior to the closing which he did not attend" (A.90).[21] The presence of Bankers Trust and its attorneys at the closing cannot be said to have caused Mallis and Kupferman to enter into the transaction whereby they loaned money to Arnold and

[21] Not only did the pleadings as amplified by the affidavits demonstrate the "lack of nexus" between Mallis and Kupferman and Bankers Trust necessary to bring a 10(b) action but the question was expressly resolved against them by Justice Nadel in the State Court action from which no appeal was taken. Mallis is attempting to relitigate the very same issue in the very same transaction in Federal Courts. This issue is barred by "collateral estoppel". Although the Court of Appeals did not resolve this question and reserved the matter for trial (A.165, Footnote 12), other Federal Courts have held that a state court determination on issues could be given collateral estoppel effect with respect to the same issues in a federal securities case arising under the 1934 Act. *McNally* v. *Esmark*, CCH Federal Securities Law Reporter, Paragraph 96,071 at p. 91, 819 (N.D. Ill. 1977) citing *inter alia Clark* v. *Watchie*, 513 F.2d 994 (CA 9 1975) *cert. denied* 423 U.S. 841 (1976); *Abramson* v. *Penwood Investment Corp.*, 392 F. 2d 759 (C.A. 2, 1968). *McNally* relied on Section 68 of Restatement of Judgments 2d. and held that such findings which were neceessary to the prior judgments are plainly binding in a securities action, and thus plaintiffs were precluded from pursuing their securities law claim.

Fowler collateralized by the Equity National stock. The agreement between Arnold, Fowler and Kates had been consummated on February 24, more than one week before the closing. Mallis and Kupferman had likewise entered into the agreement between Arnold and Fowler to make a loan collateralized by the Equity National stock before the closing. Mallis and Kupferman admittedly did not contact Bankers Trust and cannot be said to have relied upon any representations or misrepresentations of Bankers Trust prior to their agreement. All that Bankers Trust and its attorney did, was upon repayment of its indebtedness, release to its borrower the collateral which had been previously pledged. By that time all of the agreements had been fully negotiated. Mallis and Kupferman had signed the notes. The closing was a mere formality. There was plainly no "nexus" between Bankers Trust's release of the collateral and the pledge of the collateral to plaintiffs by Arnold. See *Tully* v. *Mott Supermarkets*, 540 F.2d 187 (C.A. 3, 1976), *Ketchum* v. *Green*, —— F.2d ——, unofficially reported at CCH Federal Securities Law Reporter Paragraph 96,107 (C.A. 3, 1977) where the court ruled that "the deceptive practices" in which the defendant had engaged and "the ultimate sale" of securities were "not tied sufficiently tightly so as to surmount the 'connection' requirement of § 10(b) . . ."

The crux of the complaint is that Bankers Trust's attorney should have advised plaintiffs at the closing that there were problems with the pledged stock (A.71-72, 79-80). But plaintiffs did not attend the closing. Although the courts below assumed that Bankers Trust and its attorney made affirmative misrepresentations at the closing (A.135, 159), Mallis in his complaint in the state court proceeding sworn to on December 6, 1972 expressly stated that Bankers Trust and its attorney made no representations, but "silently and without disclosure" permitted Kates to deliver a false affidavit to Arnold and "made no effort to inform" Arnold of the falsity of such statement (A.75-76). It was

only after it became apparent that the action against Bankers Trust could not stand under § 10(b) that Mallis and Kupferman asserted for the first time on May 14, 1975 that Bankers Trust "withheld vitally material information from us" and "as we are informed, actually misrepresented that the securities in question were genuine when in fact they were not not" (A.110).

In this case, as in *Amend* v. *Hurley*, 293 N.Y. 96, 59 N.E. 2d 419 (1944), Mallis was represented by his own attorney Arnold (A.71-72, 79-80). As stated by the Court of Appeals in *Amend* v. *Hurley*, 293 N.Y. at 596 "it is not fraud for one party to say nothing on the subject where no confidential or fiduciary relation exists, and where no false statements or acts to mislead the others are made".[9]

A pledgee has no greater duty to speak to an unknown third party under the securities law than it does under state law. See *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 98-99 (C,A. 5, 1975), where the court ruled that a bank acting in accordance with its legal obligation to a pledgor has no duty of disclosure to pledgor's business associate.

There is no contention anywhere in the record that Mallis and Kupferman sought advice from Bankers Trust. Bankers Trust had no knowledge of the agreement entered into between Kateses, Arnold, Fowler and especially not with Mallis and Kupferman. Bankers Trust did not know and could not know the details of the negotiations by which Mallis and Kupferman loaned money to Arnold and Fowler.

[9] In following *Amend* v. *Hurley*, Justice Nadel was consistent with the decisions of other courts such as California where the Supreme Court in *Goodman* v. *Kennedy*, 18 Cal. 3rd 335, 345-348, 134 Cal. Rptr. 375, 382-383, 556 P. 2d 737 (1976), held in a similar situation, that an attorney was not liable for failing to disclose facts which might indicate the possibility of such adverse consequences on sale of securities to the plaintiff's attorney in conversations discussing the proposed sale.

See *Hirsch* v. *DuPont*, 553 F.2d 750, 759-763 (CA 2, 1977) where Judge Kaufman commented that "the securities laws were not enacted to protect sophisticated businessmen from their own errors of judgment. Such investors must, if they wish to recover under federal law, investigate the information available to them with the care and prudence expected from people blessed with full access to information". See also *Murphy* v. *McDonnell & Co.*, 553 F.2d 292, 296 (C.A. 2, 1977).

Mallis and Kupferman are seeking to impose upon banks, such as is Bankers Trust, a duty to police the dealings of customers merely because the collateral pledged is stock and not an automobile or accounts receivable. If banks were to become legally responsible for the adequacy and accuracy of their debtors' statements to others, they would be driven to assume an impossible role in monitoring the debtors' transactions with others whenever the collateral for an indebtedness constitutes securities. A bank, whether large or small, is ill-suited to absorb substantial liability arising out of possible securities law violations by its borrowers, the extent and magnitude of which will have no reasonable relationship to—and may substantially exceed—the amount of the loan made.

In instituting this action against Bankers Trust, Mallis and Kupferman are seeking to shift the burden of the loss which may have resulted from their dealings with Arnold, Fowler and Kates to Bankers Trust, which was completely unaware of the underlying transaction.[10]

Certainly the facts of this case did not satisfy the nexus requirement of the statute. As correctly stated by Judge Pollack (A.134) "Plaintiff loaned the funds to Arnold and Fowler, who had already contracted to buy the stock in

[10] As noted *supra*, the state court actions against Arnold, Fowler and Kates in which Bankers Trust is a third party defendant are still pending.

question. While the stock later came into plaintiff's possession as collateral for their loan, the consideration for that loan was the obligation by Arnold and Fowler to repay with a bonus . . .. To allow persons in plaintiffs situation to sue under Rule 10b-5 would be to expand the class of prospective litigants under that rule to an extent uncalled for by the words of the rule or the statute."

Conclusion

When Congress enacted the Securities Exchange Act of 1934, Congress did not intend that a bank such as Bankers Trust should be potentially liable under Section 10(b) and Rule 10b-5 whenever it releases collateral to a borrower who engages in securities transactions with third parties, of which the bank is totally unaware. While Congress did not exempt banks from liability under 10(b), Congress recognized that banks should have the same protection afforded other potential defendants, including the requirement that the plaintiff be a purchaser or seller "in connection with" a sale of securities.

The very same Congress which sought to protect the financial integrity of the banking system by regulating the margin purchases of securities through the Federal Reserve Board did not seek to extend banks' liability to unknown third parties engaging in securities transactions over which banks have no control. The financial integrity of banks would be exposed far beyond what banks intended when they made the loan to their customer. Congress certainly did not intend to submit banks to any greater liability and potential strike suits and vexatious litigation than it did other corporate defendants as set forth in *Blue Chip Stamps*. See 421 U.S. at 742-749.

For these reasons the judgment of the Court of Appeals should be reversed, and the judgment of the District Court dismissing the complaint against Bankers Trust Company should be reinstated.

Respectfully submitted,

Charles Leeds
Jack H. Weiner
Counsel for Petitioner,
Bankers Trust Company
1775 Broadway
New York, New York 10019

August 18, 1977

STATUTORY APPENDIX

Statutes Involved

Section 3(a) of the Securities Exchange Act of 1934, 15 USC § 78c(a), as amended provides in relevant part:

• • •

"(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.

(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

• • •

Section 10 of the Securities Exchange Act of 1934, 15 USC § 78j, 48 Stat. 891, as amended, provides in relevant part:

"It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR (Code of Federal Regulations) § 240.10b-5 provides in relevant part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange,

• • •

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Penal Law

§ 190.40 Criminal usury

A person is guilty of criminal usury when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding twenty-five percentum per annum or the equivalent rate for a longer or shorter period.

• • •

The Uniform Commercial Code, as enacted in New York, provides in relevant part.

§ 9-305. When Possession by Secured Party Perfects Security Interest Without Filing

A security interest in letters of credit and advices of credit (Subsection (2) (a) of Section 5—116), goods, instruments, negotiable documents or chattel paper may be perfected by the secured party's taking possession of the collateral. If such collateral other than goods covered by a negotiable document is held by a bailee, the secured party is deemed to have possession from the time the bailee receives notification of the secured party's interest. A se-

curity interest is perfected by possession from the time possession is taken without relation back and continues only so long as possession is retained, unless otherwise specified in this Article. The security interest may be otherwise perfected as provided in this Article before or after the period of possession by the secured party.

§ 9-501. Default; Procedure When Security Agreement Covers Both Real and Personal Property

(1) When a debtor is in default under a security agreement, a secured party has the rights and remedies provided in this Part and except as limited by subsection (3) those provided in the security agreement. He may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure. If the collateral is documents the secured party may proceed either as to the documents or as to the goods covered thereby. A secured party in possession has the rights, remedies and duties provided in Section 9—207. The rights and remedies referred to in this subsection are cumulative.

(2) After default, the debtor has the rights and remedies provided in this Part, those provided in the security agreement and those provided in Section 9—207.

• • •

§ 9-502. Collection Rights of Secured Party

• • •

(2) A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. If

the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency. But, if the underlying transaction was a sale of accounts, contract rights, or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

• • •

§ 9-504. Secured Party's Right to Dispose of Collateral After Default; Effect of Disposition

(1) A secured party after default may sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing. Any sale of goods is subject to the Article on Sales (Article 2). The proceeds of disposition shall be applied in the order following to

(a) the reasonable expenses of retaking, holding, preparing for sale, selling, leasing and the like and, to the extent provided for in the agreement and not prohibited by law, the reasonable attorneys' fees and legal expenses incurred by the secured party;

(b) the satisfaction of indebtedness secured by the security interest under which the disposition is made;

(c) the satisfaction of indebtedness secured by any subordinate security interest in the collateral if written notification of demand therefor is received before distribution of the proceeds is completed, but only to the extent of the proceeds undistributed when such notification is received. If requested by the secured party, the holder of a sub-

ordinate security interest must seasonably furnish reasonable proof of his interest, file with the secured party a sufficient indemnity bond, and satisfy any other reasonable requirements imposed by the secured party, and unless he does so, the secured party need not comply with his demand.

(2) If the security interest secures an indebtedness, the secured party must account to the debtor for any surplus, and, unless otherwise agreed, the debtor is liable for any deficiency.

• • •

(3) Disposition of the collateral may be by public or private proceedings and may be made by way of one or more contracts. Sale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended dispostion is to be made shall be sent by the secured party to the debtor, and except in the case of consumer goods to any other person who has a security interest in the collateral and who has duly filed a financing statement indexed in the name of the debtor in this state. The secured party may buy at any public sale and if the collateral is of a type customarily sold in a recognized market or is of a type which is the subject of widely distributed standard price quotations he may buy at private sale.

(4) When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for

value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The purchaser takes free of all such rights and interests even though the secured party fails to comply with the requirements of this Part or of any judicial proceedings

(a) in the case of a public sale, if the purchaser has no knowledge of any defects in the sale and if he does not buy in collusion with the secured party, other bidders or the person conducting the sale; or

(b) in any other case, if the purchaser acts in good faith.

• • •

§ 9-506. Debtor's Right to Redeem Collateral

At any time before the secured party has disposed of collateral or entered into a contract for its disposition under Section 9—504 or before the obligation has been discharged under Section 9—505(2) the debtor or any other secured party may unless otherwise agreed in writing after default redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party in retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys' fees and legal expenses.

§ 9-507. Secured Party's Liability for Failure to Comply With This Part

(1) If it is established that the secured party is not proceeding in accordance with the provisions of this Part disposition may be ordered or restrained on appropriate

terms and conditions. If the disposition has occurred the debtor or any person entitled to notification or whose security interest has been made known to the secured party prior to the disposition has a right to recover from the secured party any loss caused by a failure to comply with the provisions of this Part.

• • •

APPENDIX

Letterhead of Helfand, Lesser, Moriber & Feldman.

August 25, 1970

Mr. Philip Greene
Bankers Trust Co.
85 Delancey Street
New York, New York

Dear Mr. Greene:

Our client, Mr. Jerome B. Kates, has pending before you a request for a loan in the sum of $30,000.00, said loan to be collateralized by approximately 40,000 shares of Equity National Industries, Inc., common stock.

Equity National Industries, Inc. is a conglomerate based in Atlanta, Georgia. Its shares are currently traded over-the-counter, selling at approximately $6.25 bid, and it is listed daily in the Wall Street Journal and the New York Times. Equity National Industries, Inc. has pending an application for listing on the American Stock Exchange and has been informed by the Exchange that it meets all requirements for listing.

Mr. and Mrs. Kates acquired their shares pursuant to an Agreement and Plan of Reorganization dated July 23, 1970 between Equity and Take Two, Inc., a New York corporation of which Mr. Kates is president. A copy of said Agreement is being submitted for your examination.

Under the aforesaid Agreement, the shareholders of Take Two, Inc. are to receive as an original payment in exchange for all of the shares of Take Two, Inc., a maximum of 175,000 shares of Equity provided that Take Two, Inc. shall earn an amount equal to or in excess of $350,000 net before taxes for the calendar year December 31, 1970, and that the net worth of Take Two, Inc. shall be equal

to or in excess of $225,000.00 at December 31, 1970. By reason of the fact that at the time of the closing on August 7, 1970 it was determined that Take Two, Inc. had already earned $130,000.00 pre-tax for the first six months of the calendar year 1970 ending July 30, 1970, 65,000 shares of Equity were delivered to the stockholders of Take Two, Inc. at the closing, the balance of 110,000 shares being held in escrow in accordance with an Escrow Agreement (marked Exhibit "B") dated August 7, 1970, until a determination can be made at the close of the calendar year as to the final net before tax earnings and net worth of Take Two, Inc. for the calendar year ended December 31, 1970. A copy of this Escrow Agreement is submitted herewith for your examination.

The stock certificates of Equity being submitted to you as collateral bear on the back a legend referring to the aforementioned Escrow Agreement. The reason for this being that if the before tax earnings of Take Two, Inc. are less than $350,000.00 for the calendar year 1970 and/or the net worth of Take Two, Inc. is less than $225,000.00 at December 31, 1970, the shareholders of Take Two, Inc. would receive a lesser number of shares than 175,000 shares in accordance with a formula set forth in Paragraph "4" of said Escrow Agreement. Only if Take Two, Inc. were to sustain losses for the last six months of this year in an amount sufficient to eliminate the $130,000.00 previously earned in the first six months of the year, would the stockholders of Take Two, Inc. including Mr. and Mrs. Kates, be required to return any of the 65,000 shares of Equity previously delivered to them at the closing. In this connection we wish to advise you that in addition to the $130,000.00 pre-tax earnings for the first six months, Take Two, Inc. has earned approximately $60,000.00 pre-tax for the period of July and

August, 1970. In addition, the company has recently employed an additional salesman and director, which additions are expected to increase the monthly earnings for the remainder of the year. It is the opinion of management that Take Two, Inc. will have no difficulty in earning the required $350,000.00 pre-tax earnings for this calendar year and will have the required $225,000.00 net worth as of December 31, 1970 which will entitle the shareholders to receive the additional 110,000 shares of Equity now being held in escrow.

In accordance with the Agreement between Equity and Take Two, Inc. the shareholders of Take Two, Inc. shall be entitled to receive in the following four years after December 31, 1970, an amount of shares equal to the total number of shares received at the end of 1970, in accordance with a formula set forth in Paragraph "3", Page 8 of the Agreement. This, therefore, will enable the stockholders to receive a maximum of an additional 175,000 shares or a total of 350,000 shares. Said shares may be received in a lesser period of time than four years, depending upon the earnings of Take Two, Inc.

Mr. Kates was the major stockholder of Take Two, Inc. and as such received approximately 40,000 shares of the 65,000 shares already delivered at the closing. He will receive the same proportion of the 110,000 shares being held in escrow for delivery at the end of this year and will also be entitled to receive the same proportion of the remaining 175,000 shares which may be delivered in the following four years or less.

We wish to further direct your consideration to the provisions of the contract under Paragraph "2", a, b and c, Page 6A, 7 and 8, which provided that Equity shall deliver to the stockholders of Take Two, Inc., an additional 58,000 shares of Equity if the average market price of

Equity common stock shall not exceed $12.00 per share for the month of December, 1971. Said shares have also been placed in escrow pursuant to an Escrow Agreement dated August 7, 1970, a copy of which is submitted to you herewith. Mr. Kates again would be entitled to receive the same proportion of said shares as previously referred to.

It is our opinion that the shares of stock proposed to be delivered to you as collateral by Mr. and Mrs. Kates, although bearing the usual restrictive legend covering unregistered securities, will become eligible for public sale without registration after six months from the date of closing on August 7, 1970, under the provisions of Section 154 of the Securities and Exchange Act as amended, (the so-called 1% rule). There are presently outstanding in excess of 2,000,000 shares of common stock of Equity which would enable Mr. Kates to sell up to 20,000 shares of Equity stock within a six month period. Management and counsel to Equity have concurred in this opinion.

If there is any further information which we can supply which will be of help to you, please feel free to call upon us.

Very truly yours,

ROBERT HELFAND
Robert Helfand

RH:ls

Letterhead of Schwartz, Mermelstein, Burns, Lesser & Jacoby.

April 21, 1971

Bankers Trust Company
85 Delancey Street
New York, New York 10022

Re: Jerome B. Kates—Loan and Collateral Security

Gentlemen:

We represent Mr. Jerome B. Kates and his wife Judith Kates.

We have been advised by our clients that in connection with the loan made by you in September, 1970 to Mr. Kates in the amount of $50,000.00, they delivered to you as collateral security for the loan the following shares of the capital stock of Equity National Industries, Inc. (Equity):

Twenty Nine Thousand Eight Hundred Twenty One (29,821.00) shares issued to Jerome B. Kates, as evidenced by Certificate #U 1833; and,

Ten Thousand Five Hundred Sixty Three (10,563.00) shares issued to Judith Kates, as evidenced by Certificate #U 1828

(The "Securities")

We further understand that you are in receipt of a letter from Equity demanding its prior approval of your disposition of the Securities.

This is to inform you that we have advised our clients that notwithstanding any controversy between Equity and them respecting the conditions of issuance of the Securities, since they delivered them to you as collateral for the

loan they have every right to expect you to return the Securities to them upon repayment of the loan.

This letter is intended to advise you that our clients will hold you fully responsible for any damages which may be sustained by them in the event you fail to return the Securities to them at such time as your loan to Mr. Kates has been repaid.

Very truly yours,

SCHWARTZ, MERMELSTEIN, BURNS, LESSER & JACOBY

By EVERETT A. FROLICH
Everett A. Frohlich

EAF/cg

HAND DELIVERED

May 24, 1971

E. Cooke Rand, Esq.
Weiss, Preston, Rosenthal,
Heller and Schwartz
295 Madison Avenue
New York, New York 10017

Re: Take Two, Inc. and
Jerome and Judith Kates

Dear Mr. Rand:

This is in confirmation of my telephone conversation with you last Friday to the effect that Bankers Trust Company declines to deliver to Equity National Industries, Inc. the Certificates of Stock demanded by your corresponding attorneys of Atlanta, Georgia, in their letter of April 14, 1971, addressed to Bankers Trust Company at 85 Delancey Street, New York, N.Y.

As I explained to you, the above mentioned shares of stock were delivered to the Bank by Jerome B. Kates as collateral security for loans made to him and will be returned to him only when said loans are repaid.

Bankers Trust Company does not intend to get into any dispute that you may have concerning his right to the said shares of stock.

Moreover, the Bank has been put on written notice by the attorneys representing Mr. Kates, not to release the said collateral upon penalty of damages. If your client is disposed to furnishing the Bank with an Indemnity Bond to fully protect the Bank in this matter, we will consider your client's demand. Otherwise, you may consider this letter as a rejection.

Very truly yours,

NATHAN SILVERMAN

NS:am